No. 77-920

In the Supreme Court of the United States

OCTOBER TERM, 1977

THOR POWER TOOL COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

WADE H. McCREE, JR.,
Solicitor General,
M. CARR FERGUSON,
Assistant Attorney General,
ANN BELANGER DURNEY,
WILLIAM A. WHITLEDGE,
Attorneys,
Department of Justice,
Washington, D.C. 20530.

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OPINIONS BELOW

The opinion of the Tax Court (Pet. App. A–6 to A–32) is reported at 64 T.C. 154. The opinion of the court of appeals (Pet. App. A–34 to A–48) is reported at 563 F. 2d 861.

JURISDICTION

The judgment of the court of appeals was entered on September 29, 1977. The petition for a writ of certiorari was filed on December 27, 1977. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether petitioner failed to meet its burden of proving that its method of valuing its inventory clearly reflected its income for federal income tax purposes.

2. Whether petitioner failed to prove that the Commissioner's rejection of its method of computing its reserve for bad debts was an abuse of discretion.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Sections 166, 446, and 471 of the Internal Revenue Code of 1954 (26 U.S.C.) and Treasury Regulations, Sections 1.166–4, 1.446–1 (a), 1.471–2, and 1.471–4 are set forth at Pet. App. A–1 to A–5.

STATEMENT

1. Petitioner is a manufacturer of tools, parts and accessories. Each of petitioner's sales branches maintains inventories of spare parts and accessories for each tool it manufactures. Petitioner employs the "lower of cost or market" method of valuing its inventory for both financial reporting and federal income tax purposes (Pet. App. A–35 to A–36).

In 1964, petitioner's new management determined that the quantities of raw materials, work-in-process, finished tools and spare parts in inventory was far in excess of what could be sold. After taking an inventory of these items, petitioner wrote off all of its obsolete items of inventory.[1] Petitioner also wrote

[1] The Commissioner permitted that inventory write-off and it is not in issue here.

down the remaining 44,000 items in its inventory to their "net realizable value," as accounting standards required (Pet. App. A–36 to A–37).

Petitioner computed the "net realizable value" of its inventory by estimating the future demand for each item and then writing down the value of each item in inverse proportion to its estimated future demand.[2] Petitioner did not, however, attempt to dispose of any of the items it deemed to be in excessive supply, to segregate the items in its inventory, or to identify any particular item as in excess supply. Petitioner achieved its reduction in its inventory values by means of an inventory reserve account, to which it credited the amounts of the write-downs. Petitioner recorded the corresponding debit as an expense on its financial statements and deducted the amount on its 1964 income tax return (Pet. App. A–36 to A–37).

On audit, the Commissioner of Internal Revenue disallowed petitioner's deductions for inventory devaluation on the ground that they did not clearly reflect its income for federal tax purposes. Petitioner sought

[2] Petitioner reduced its gross usable inventory in the following manner (Pet. App. A–37 n. 6):

"(1) Items not in excess of 12 months' anticipated demand were not written down.

"(2) Items in excess of 12 months' anticipated demand but not in excess of 18 months' anticipated demand were written down 50 percent.

"(3) Items in excess of 18 months' anticipated demand but not in excess of 24 months' anticipated demand were written down 75 percent.

"(4) Items in excess of 24 months' anticipated demand were written off completely."

review of the Commissioner's determination in the Tax Court. The Tax Court held that petitioner had failed to show the Commissioner had abused his discretion in determining that petitioner's inventory write-downs did not clearly reflect its income. In the Tax Court's view, petitioner's write-down of excess inventory was not permitted by the Treasury Regulations, Section 1.471–1 *et seq.*, which requires that "market" value of an inventry be computed on the basis of "replacement cost" rather than "net realizable value" (Pet. App. A–17 to A–30). The court of appeals affirmed (Pet. App. A–34 to A–47).

2. In 1965, petitioner reviewed each of its outstanding accounts receivable and estimated their collectibility. Petitioner then applied various percentages to the accounts reflecting their estimated degrees of uncollectibility and added the resulting amounts to its bad debt reserve. On its 1965 tax return, petitioner deducted the addition to its bad debt reserve (Pet. App. A–47 to A–48).

The Commissioner rejected petitioner's method of computing its bad debt reserve. He recomputed what he considered to be a reasonable addition to petitioner's reserve on the basis of petitioner's bad debt experience pursuant to the formula in *Black Motor Co.* v. *Commissioner,* 41 B.T.A. 300 (Pet. App. A–48). The Tax Court held that petitioner failed to sustain its burden of showing that the Commissioner's determination was an abuse of discretion (Pet. App. A–31 to A–32) and the court of appeals affirmed (Pet. App. A–47 to A–48).

ARGUMENT

1. Section 471 of the Internal Revenue Code of 1954 provides that when the inventory method is necessary clearly to reflect a taxpayer's income, the Secretary of the Treasury may prescribe the basis upon which such inventories shall be taken. Section 471 prescribes that the method of computing inventories must meet a two-part test: (1) it must approximate the best accounting practice of the particular business; and (2) it must clearly reflect income. Treasury Regulations Section 1.471–1 *et seq.* permit the use of the lower of cost or market method of valuing inventories and require that any inventory valuation method clearly reflect the taxpayer's income and that a taxpayer's inventory method be consistent from year to year and comply with Treasury Regulations, Sections 1.471–1 through 1.471–11. See Treasury Regulations, Section 1.471–2.[3]

The substance of the Regulations is that a taxpayer employing the lower of cost or market inventory method must compute "market" value as replacement or reproduction cost. If the taxpayer does not compute market value of its inventory in accordance with

[3] Petitioner did not challenge the validity of the Regulations in the courts below. However, it now asserts (Pet. 21–22) that the decision below elevates the Regulations to the status of a statute. It is well established that Regulations not inconsistent with the statute should be sustained if they are reasonable. *Commissioner* v. *South Texas Lumber Co.*, 333 U.S. 496; *United States* v. *Correll*, 389 U.S. 299. Moreover, since the Regulations here in question were issued pursuant to the express statutory authority of Section 471, they are legislative in character and are given the force and effect of law. *Panama Refining Co.* v. *Ryan*, 293 U.S. 388.

replacement cost, it has the burden to prove that its method clearly reflects its income.

In mid-1964, petitioner changed its inventory method to compute the "market" value of its inventory on the basis of "net realizable value" rather than replacement cost. In the Tax Court, petitioner presented expert testimony which established that its computation of "market" value on the basis of "net realizable value" was in accord with generally accepted accounting principles. However, petitioner presented no evidence that its method clearly reflected its income for federal income tax purposes. Accordingly, the court of appeals (Pet. App. A–45 to A–46) correctly concluded that the Tax Court was not clearly erroneous in finding that petitioner did not prove that its inventory method clearly reflected its 1964 income.

Petitioner renews the argument (Pet. 13–16), rejected by the courts below, that if a taxpayer's method of inventory valuation conforms with generally accepted accounting principles, there is a presumption that the method clearly reflects its income for tax purposes.[4] The contrary is true, however. It is well settled that tax accounting principles differ from generally accepted accounting principles, and that compliance with generally accepted accounting principles does not establish that a taxpayer's method of accounting clearly reflects its income for income tax purposes.

[4] As the court of appeals further noted (Pet. App. A–45), even if there were such a presumption, it was rebutted by petitioner's lack of consistency in computing the "market" value of its opening inventory in 1964 at replacement cost, and its closing inventory at "net realizable value."

See, *e.g.*, *American Automobile Association* v. *United States*, 367 U.S. 687; *Schlude* v. *Commissioner*, 372 U.S. 128.[5]

Moreover, the courts below correctly held that petitioner's method of computing the market value of its inventory was not permitted by the Regulations under Section 471. Section 1.471–2(c) permits the taxpayer to use special valuation procedures for inventory which it proves is "unsalable at normal prices * * * because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes * * *." But as the court of appeals pointed out (Pet. App. A–42), this provision of the Regulation was inapplicable because petitioner failed to prove that its excess inventory was "unsalable at normal prices." Moreover, petitioner did not make an "actual offering" within 30 days of the inventory date to establish a bona fide selling price, as required by Section 1.471–2(c) of the Regulations (see Pet. App. A–42 to A–43 and n. 14).[6]

Finally, contrary to petitioner's contention (Pet. 10), the decision below does not conflict with

[5] Petitioner urges (Pet. 11–12) this Court to "provide guidance concerning the extent to which the Commissioner may exercise his discretion in rejecting generally accepted accounting principles." But the Court has already spoken on the question in *American Automobile Association* v. *United States*, *supra*, 367 U.S. at 692, and *Schlude* v. *Commissioner*, *supra*. In those cases, it held that the Commissioner has broad discretion to require that a taxpayer's method of accounting clearly reflects its income despite its use of a generally accepted method of accounting. Moreover, the detailed Regulations under Section 471 are sufficient to define and limit the Commissioner's discretion.

[6] Nor does Section 1.471–4(b) of the Regulations support petitioner's claimed inventory write-down. The evidence showed that

Space Controls, Inc. v. *Commissioner,* 322 F. 2d 144 (C.A. 5), or *E. W. Bliss Co.* v. *United States,* 224 F. Supp. 374 (N.D. Ohio), affirmed *per curiam,* 351 F. 2d 449 (C.A. 6). In *Space Controls,* the court held that the taxpayer's write-down of inventory qualified under the specific language of Section 1.471–4(b) of the Regulations (see 322 F. 2d at 151–153). Likewise, in *E. W. Bliss Co.,* the court found that the taxpayer had proved that it had followed its method of inventory valuation for 30 years and that it clearly reflected its income (224 F. Supp. at 385). Here, however, petitioner concedes (Pet. 21), and the courts below concluded (Pet. App. A–41 to A–42), that its write-down of its inventory was not authorized by the Regulations.[7]

2. The court of appeals also correctly held that the Commissioner did not abuse his discretion in rejecting petitioner's method of computing its bad debt reserve. Section 166(a) of the Code permits a taxpayer to claim a deduction for specific debts as they become worthless. Section 166(c) provides that, in lieu of the specific write-off method authorized by Section 166 (a), "there shall be allowed (in the discretion of the Secretary or his delegate) a deduction for a reasonable addition to a reserve for bad debts." A reasonable addition to a bad debt reserve is the amount necessary to bring the balance in the reserve account to a level that can be reasonably expected to cover the losses anticipated with respect to debts outstanding at the end of the year. *Dixie Furniture Co.* v. *Commissioner,* 390 F. 2d 139 (C.A. 8).

At the close of 1965, petitioner estimated the collectibility of each of its accounts. It set aside a 100 percent reserve for accounts it considered to be wholly uncollectible. It also applied the dollar ratio of uncollectible accounts to the total amount of accounts of more than $100 and applied this fraction to 90-day-old accounts with a balance of under $100. Moreover, it established a flat two percent reserve for all other 90-day accounts and all accounts between 30 and 90 days past due. Finally, petitioner established a one percent reserve for all accounts less than 30 days old (Pet. App. A–47). These computations resulted in a total addition to petitioner's bad debt reserve of $135,150 (Pet. App. A–48).

Pursuant to his authority under Section 166(c), the Commissioner recomputed petitioner's bad debt reserve by applying the formula adopted in *Black Motor Co.* v. *Commissioner,* 41 B.T.A. 300, affirmed on other grounds, 125 F. 2d 977 (C.A. 6). This formula measures the current addition to the bad debt reserve based upon the average annual losses from accounts receivable during the six-year period ending with the close of the taxable year (see 41 B.T.A. at 302). The *Black Motor* formula yielded an addition to petitioner's bad debt reserve of $74,790.80 (Pet. App. A–48).

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it was not unusual for companies engaged in petitioner's business to carry excess inventory. Hence, the valuation procedures applicable where there are "inactive market conditions" (Section 1.471–4(b)) have no pertinence to this case.

[7] *C–O–Two Fire Equipment Co.* v. *Commissioner,* 219 F. 2d 57, 59 (C.A. 3), upon which petitioner relies (Pet. 25–26), is also distinguishable. There, it was undisputed that the taxpayer's inventory became obsolete. The sole question was whether it did so in 1946 or 1947.

As the court of appeals observed, Section 166(c) gives the Commissioner discretion to determine the reasonableness of any addition by a taxpayer to a bad debt reserve. In order to overturn the Commissioner's determination, the taxpayer must show an abuse of that discretion. *Calavo, Inc.* v. *Commissioner,* 304 F. 2d 650, 653–655 (C.A. 9); *Consolidated-Hammer Dry Plate & Film Co.* v. *Commissioner,* 317 F. 2d 829, 834 (C.A. 7); *Akron National Bank & Trust Co.* v. *United States,* 510 F. 2d 1157 (C.A. 6); *Merchants Industrial Bank* v. *Commissioner,* 475 F. 2d 1063 (C.A. 10); *Paramount Finance Co.* v. *United States,* 304 F. 2d 460 (Ct. Cl.). Petitioner has not done so.

Contrary to petitioner's argument (Pet. 29–30), the decision below does not conflict with *Rhode Island Hospital Trust Co.* v. *Commissioner,* 29 F. 2d 339 (C.A. 1), *Calavo, Inc.* v. *Commissioner, supra,* or *Travis* v. *Commissioner,* 406 F. 2d 987 (C.A. 6). In each of those cases, the courts reaffirmed the Commissioner's statutory discretion with respect to bad debt reserves. However, the taxpayers were able to demonstrate on the evidence that the Commissioner's recomputation of their bad debt reserve was an abuse of discretion. Here, on the other hand, petitioner failed to make that showing. The court of appeals correctly concluded that "the Commissioner's method of determining the reserve for bad debts, which gave preference to experience over estimates, was reasonable" (Pet. App. A–48).

CONCLUSION

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

WADE H. MCCREE, JR.,
Solicitor General.
M. CARR FERGUSON,
Assistant Attorney General.
ANN BELANGER DURNEY,
WILLIAM A. WHITLEDGE,
Attorneys.

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